

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-82575; File No. TP 18-08)

January 23, 2018

Order Granting Limited Exemptions from Rules 101 and 102 of Regulation M in Connection with Distributions of AT1 Contingent Convertible Securities Pursuant to Rules 101(d) and 102(e) of Regulation M

By letter dated January 23, 2018, counsel from Sullivan & Cromwell LLP and Davis Polk & Wardell LLP (collectively, the “Applicants”),<sup>1</sup> requested that the staff of the Division of Trading and Markets grant, on behalf of certain European financial institutions (each, an “Issuer”), conditional class exemptive or no-action relief from Rules 101 and 102 of Regulation M under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), to permit certain transactions in ordinary shares underlying the contingent convertible debt securities qualifying as additional tier 1 capital (“AT1 Contingent Convertible Securities”), including ordinary shares represented by American depositary shares (collectively, “Shares”), by Issuers and affiliated purchasers, including those acting as distribution participants, during a distribution of such AT1 Contingent Convertible Securities.<sup>2</sup>

AT1 Contingent Convertible Securities

Over the last several years, a number of European financial institutions have issued various series of AT1 Contingent Convertible Securities that are designed to qualify as additional

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<sup>1</sup> Letter from John O’Connor, Sullivan & Cromwell LLP, and John Banes, Davis Polk & Wardell LLP, to Josephine J. Tao, Assistant Dir., Office of Derivatives Policy & Trading Practices, Div. of Trading & Mkts., SEC (Jan. 23, 2018) (the “Request Letter”).

<sup>2</sup> The requested relief is solely to permit transactions in Shares during a distribution of an Issuer’s AT1 Contingent Convertible Securities (i.e., the Request Letter does not seek relief with respect to transactions in the AT1 Contingent Convertible Securities themselves). For purposes of this relief, the terms “affiliated purchasers” and “distribution participants” shall have the same meaning as defined in Rule 100(b) of Regulation M. See 17 CFR 242.100(b).

tier 1 capital (“AT1 Capital”) that can be counted by a financial institution towards the capital requirements mandated by European regulators.<sup>3</sup>

Applicants represent in the Request Letter that the AT1 Contingent Convertible Securities to be offered are fundamentally fixed-income debt securities that are priced and traded by investors as such.<sup>4</sup> Applicants also represent in the Request Letter that, unlike traditional convertible debt instruments, the AT1 Contingent Convertible Securities to be offered automatically convert into Shares only upon the occurrence of a remote, capital adequacy-related trigger event that is set forth in the terms of the relevant AT1 Contingent Convertible Security.

Specifically, Applicants represent, among other things, the following:

- Relief is requested only with respect to AT1 Contingent Convertible Securities that automatically and mandatorily convert into Shares if the Issuer’s Common Equity Tier 1

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<sup>3</sup> Applicants represent in the Request Letter that the qualification requirements/features for AT1 Contingent Convertible Securities that qualify as AT1 Capital are set forth in the European Union’s Capital Requirements Directive IV and related Capital Requirements Regulation (collectively, the “CRD IV”), which were issued in response to the new global regulatory frameworks on bank capital adequacy and liquidity adopted by the Basel Committee on Banking Supervision in December 2010 (generally known as “Basel III”). Applicants represent that the purpose of AT1 Capital is to absorb future losses through conversion to common equity (or write-down) so as to allow a financial institution to maintain sufficient Common Equity Tier 1 Capital to continue as a going concern. In addition, the basic equity-related-structure of AT1 Contingent Convertible Securities that qualify as AT1 Capital under CRD IV is summarized in the Request Letter.

<sup>4</sup> Applicants also represent that Issuers have previously indicated that they expect AT1 Contingent Convertible Securities to price and trade more like traditional fixed-income debt instruments than conventional convertible instruments (*i.e.*, that investors in AT1 Contingent Convertible Securities are generally focused on receiving interest payments during the life of the AT1 Contingent Convertible Securities rather than any potential equity upside in the unlikely event of a conversion into Shares), citing to prior requests for relief from Rules 101 and 102 of Regulation M in connection with offerings of AT1 Contingent Convertible Securities: Letter from Josephine J. Tao, Assistant Dir., Office of Derivatives Policy & Trading Practices, Div. of Trading & Mkts., SEC, to Mark J. Welshimer, Sullivan & Cromwell LLP (Apr. 7, 2015) (ING Groep N.V.); Letter from Josephine J. Tao, Assistant Dir., Office of Derivatives Policy & Trading Practices, Div. of Trading & Mkts., SEC, to John Baner, Davis Polk & Wardwell London LLP (Mar. 6, 2014) (Lloyds Banking Group); Letter from Josephine J. Tao, Assistant Dir., Office of Derivatives Policy & Trading Practices, Div. of Trading & Mkts., SEC, to George H. White, Sullivan & Cromwell LLP (Nov. 7, 2013) (Barclays PLC); Letter From Josephine J. Tao, Assistant Dir., Office of Derivatives Policy & Trading Practices, Div. of Trading & Mkts., SEC, to Michael J. Willisch, Davis Polk & Wardwell Spain LLP (Nov. 3, 2017) (Banco Bilbao Vizcaya Argentaria, S.A.).

Capital Ratio (as calculated in accordance with CRD IV) falls below a pre-determined trigger level of 7.0% or lower;<sup>5</sup>

- A Common Equity Tier 1 Capital Ratio below 7.0% is effectively a sign of distress, and conversion of AT1 Contingent Convertible Securities with a trigger level of 7.0% or lower is unlikely to occur as a result of actions within an Issuer's control;
- Because of the perceived severity of the regulatory sanctions that would otherwise apply to an Issuer who allows its Common Equity Tier 1 Capital Ratio to fall below its Combined Buffer Requirement,<sup>6</sup> Issuers have a strong incentive to maintain capital levels, and investors expect such Issuers to maintain capital levels, well in excess of the pre-determined trigger level;<sup>7</sup>
- Because the risk of regulatory capital falling below the pre-determined trigger level is considered remote at the time of the issuance, the price of the Shares is not expected to

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<sup>5</sup> Applicants represent that guidance from the UK Prudential Regulation Authority will generally result in a 7.0% trigger level for AT1 Contingent Convertible Securities issued by UK financial institutions, which is intended to ensure that only instruments that will reliably absorb losses while a firm is still a going concern can count towards the leverage ratio under CRD IV. Applicants represent that the applicable 7.0% threshold is equivalent to the sum of the basic 4.5% minimum for Common Equity Tier 1 Capital under CRD IV and the additional 2.5% capital conservation buffer that is also required to be satisfied with Common Equity Tier 1 Capital under CRD IV.

<sup>6</sup> In addition to the basic 4.5% minimum Common Equity Tier 1 Capital Ratio under CRD IV, there is a Combined Buffer Requirement applicable to any institution that is incremental to the minimum requirement and is composed of (1) in all cases, an additional 2.5% capital conservation buffer (with the consequence that the sum of the basic minimum and the Combined Buffer Requirement is never less than 7.0%), and (2) at least three other potential buffers—namely, (i) an institution-specific counter-cyclical capital buffer (which may be disapplied by member states to small and medium-sized institutions), (ii) a member state-specific systemic risk buffer, and (iii) any applicable systemically important institution buffers.

<sup>7</sup> Applicants represent that the CRD IV regulatory sanctions include automatic limitations on distributions (such as the ability to pay dividends) and compensation that create significant disincentives for an Issuer to allow its Common Equity Tier I Capital Ratio to fall below the applicable Combined Buffer Requirement.

have a significant impact on pricing or market demand for AT1 Contingent Convertible Securities at the time of issuance;

- Because AT1 Contingent Convertible Securities would convert only if Common Equity Tier 1 Capital fell below the pre-determined trigger level of at least 7.0%, which would, effectively, indicate distress of the Issuer, investors do not purchase AT1 Contingent Convertible Securities in the initial distribution of AT1 Contingent Convertible Securities to have the possibility of acquiring Shares in a conversion or to increase their exposure to the Issuer's common equity (i.e., investors, instead, are focused primarily on receiving interest payments during the life of the AT1 Contingent Convertible Securities);
- Accordingly, trading activity in the Shares at or around the time of distribution is unlikely to influence the pricing or trading of the AT1 Contingent Convertible Securities that would be in distribution.

## **I. RULES 101 and 102 of REGULATION M**

Rule 101 of Regulation M is an anti-manipulation rule that, subject to certain exceptions, prohibits any “distribution participant” (i.e., underwriters, brokers, dealers, or other persons who have agreed to participate or are participating in a distribution of securities) and its “affiliated purchasers” from bidding for, purchasing, or attempting to induce any person to bid for or purchase, any security that is the subject of a distribution until after the applicable restricted period, except as specifically permitted in the Rule. Rule 102 of Regulation M includes the same prohibitions but applies to issuers, selling security holders, and any of their affiliated purchasers.

Regulation M applies to activities in both the securities in distribution (i.e., activities in the “subject securities”) and any “reference securities,” such as common stock underlying an

exercisable, exchangeable, or convertible security that is being distributed.<sup>8</sup> Accordingly, the Issuer's Shares may be deemed to be "reference securities" in relation to the AT1 Contingent Convertible Securities. Thus, Regulation M would prohibit Issuers and any affiliated purchasers from making any bids for, purchases of, or attempts to induce any other person to bid for or purchase the Shares during an applicable restricted period in connection with a distribution of the Issuer's AT1 Contingent Convertible Securities.

### Discussion

Based on the representations and facts presented in the Request Letter—particularly, that a distribution of AT1 Contingent Convertible Securities that satisfies the conditions set forth in the Request Letter, as well as below, does not raise the concerns at which Regulation M is directed and that any bids for, purchases of, or attempts to induce any other person to bid for or purchase of the Shares by Issuers or affiliated purchasers during an applicable restricted period in connection with a distribution of the Issuer's AT1 Contingent Convertible Securities would be unlikely, except in unusual circumstances, to affect the pricing or trading of the AT1 Contingent Convertible Securities<sup>9</sup>—the U.S. Securities and Exchange Commission (the "Commission") finds that it is appropriate in the public interest and consistent with the protection of investors to grant class exemptive relief from the requirements of Rule 101 and Rule 102, under paragraph (d) of Rule 101 and paragraph (e) of Rule 102 of Regulation M, respectively, in connection with distributions of AT1 Contingent Convertible Securities that satisfy the conditions set forth below

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<sup>8</sup> See Anti-Manipulation Rules Concerning Securities Offerings, Exchange Act Rel. No. 38067 (Dec. 20, 1996), 62 Fed. Reg. 520 (Jan. 3, 1997) (stating that transactions in "reference securities" can have a direct and substantial effect on the pricing and terms of the security in distribution).

<sup>9</sup> In particular, that AT1 Contingent Convertible Securities do not convert to equity unless the Issuer's regulatory capital falls below a pre-determined trigger level, and that the price of and trading activity in Shares at or around the time of a distribution is not expected to influence or have a significant impact on pricing or market demand for the AT1 Contingent Convertible Securities at the time of issuance.

to permit transactions involving Shares by an Issuer and its affiliated purchasers (including those acting as distribution participants) during a distribution of such AT1 Contingent Convertible Securities.<sup>10</sup>

Consistent with the limited scope of relief sought in the Request Letter, this relief is limited to distributions of AT1 Contingent Convertible Securities by or on behalf of a “foreign private issuer” (within the meaning of Rule 3b-4 under the Exchange Act) and where the “principal market” (as such term is defined in Rule 100 of Regulation M) of the underlying Shares is outside of the United States. This condition narrowly tailors the relief’s application to Issuers who engage in distributions of the AT1 Contingent Convertible Securities that are the subject of this relief and ensures that the Issuers of such securities are subject to the information reporting requirements of the Exchange Act. Limiting the scope of the relief in this way should help to reduce the potential risk of transactions in Shares that could adversely affect U.S. markets during a distribution of a non-U.S. Issuer’s AT1 Contingent Convertible Securities.

This relief is also limited to distributions of AT1 Contingent Convertible Securities that automatically and mandatorily convert into Shares if an Issuer’s Common Equity Tier 1 Capital Ratio (as calculated in accordance with CRD IV) falls below a predetermined trigger level of 7.0% or lower. Applicants represent in the Request Letter that a Common Equity Tier 1 Capital Ratio below 7.0% is considered, under guidance from the UK Prudential Regulation Authority, to be effectively a sign of distress, and conversion of AT1 Contingent Convertible Securities with a trigger level of 7.0% or lower is unlikely to occur as a result of actions within an Issuer’s control. As such, this condition is intended to further ensure the remoteness of any possibility of

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<sup>10</sup> Consistent with the limited scope of relief sought in the Request Letter, the relief granted herein, however, does not extend to transactions in the AT1 Contingent Convertible Securities themselves. Transactions in the AT1 Contingent Convertible Securities that are being distributed would need to comply with the requirements of Regulation M and/or qualify for one of the exceptions provided under Regulation M.

conversion of the AT1 Contingent Convertible Securities, thus also decreasing the likelihood of any trading activity in Shares during such distributions affecting the pricing or demand for the AT1 Contingent Convertible Securities being distributed.

This relief also requires that, as of the date of the most recent calculation required to be reported to the relevant supervising authority under applicable regulatory capital rules prior to the distribution of the AT1 Contingent Convertible Securities, the Issuer's Common Equity Tier 1 Capital Ratio must exceed the applicable Combined Buffer Requirement.<sup>11</sup> This condition, which conforms to applicable regulatory capital rules, is intended to ensure that the Issuer maintains capital levels that are sufficiently above the pre-determined trigger level at the time of distribution of the AT1 Contingent Convertible Securities.<sup>12</sup> Accordingly, this condition helps to ensure the remoteness of any possibility of conversion of the AT1 Contingent Convertible Securities and, thus, to decrease the likelihood of any trading activity in Shares during such distributions affecting the pricing or demand for the AT1 Contingent Convertible Securities being distributed.

In addition, this relief applies only to AT1 Contingent Convertible Securities in distribution that do not include any right of the Issuer or holders to convert the AT1 Contingent Convertible Securities into Shares at their option. This condition is intended to help to ensure the remoteness of any possibility of conversion of the AT1 Contingent Convertible Securities and, thus, to decrease the likelihood of trading activity in Shares affecting the pricing or demand for the AT1 Contingent Convertible Securities in distribution.

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<sup>11</sup> See supra note 6.

<sup>12</sup> As mentioned above, because of the perceived severity of regulatory sanctions that would apply to an Issuer that allows its Common Equity Tier I Capital Ratio to decline below the applicable Combined Buffer Requirement, it is expected that Issuers will maintain capital levels well in excess of the predetermined trigger level.

This relief also requires that any transactions in Shares by an Issuer or any of its affiliated purchasers must be effected in the ordinary course of business and not to facilitate the distribution of the AT1 Contingent Convertible Securities. This condition should help to ensure that transactions in Shares are more customer-driven rather than driven by market activities that could potentially be used to artificially facilitate the distribution of the AT1 Contingent Convertible Securities or unduly impact the pricing of or demand for the AT1 Contingent Convertible Securities in distribution.

To ensure adequate transparency to potential U.S. investors in the offering, this relief also requires that any prospectus or other offering document that is distributed to U.S. investors in connection with the offering of the AT1 Contingent Convertible Securities must disclose the possibility of, or the intention to engage in, transactions in Shares by an Issuer or its affiliated purchasers.

This relief is also limited to Shares that qualify for the actively-traded securities exception under Rule 101(c)(1) of Regulation M because such securities are viewed by the Commission to be less susceptible to manipulation. This limitation should also help to reduce the impact of any attempt to artificially influence the price of the AT1 Contingent Convertible Securities that are being distributed by engaging in transactions in the Shares at or around the time of a distribution.

## **II. CONCLUSION**

IT IS HEREBY ORDERED, pursuant to Rule 101(d) and Rule 102(e) of Regulation M, that, based on the representations and facts presented in the Request Letter, class exemptive relief from the requirements of Rules 101 and Rule 102, respectively, is granted in connection with distributions of AT1 Contingent Convertible Securities that satisfy the conditions set forth



below to permit transactions involving Shares by an Issuer and its affiliated purchasers (including affiliated purchasers who may be deemed to be participating in a distribution of such Issuer's AT1 Contingent Convertible Securities) during a distribution of such AT1 Contingent Convertible Securities, as described in the Request Letter and herein, subject to the following conditions:

- (1) The Issuer of the AT1 Contingent Convertible Securities must be a foreign private issuer (within the meaning of Rule 3b-4 under the Exchange Act);
- (2) The principal market (within the meaning of Rule 100 of Regulation M) of Shares must be outside of the United States;
- (3) The AT1 Contingent Convertible Securities in distribution must only automatically and mandatorily convert into the Issuer's Shares if the Issuer's Common Equity Tier 1 Capital Ratio (as calculated in accordance with CRD IV) falls below a pre-determined trigger level of 7.0% or lower;
- (4) As of the date of the most recent calculation that is required to be reported to the relevant supervising authority under applicable regulatory capital rules prior to the distribution of the AT1 Contingent Convertible Securities, the Issuer's Common Equity Tier 1 Capital Ratio must exceed the applicable Combined Buffer Requirement;
- (5) The AT1 Contingent Convertible Securities in distribution must not include any right of the Issuer or holders to convert the AT1 Contingent Convertible Securities into Shares at their option;
- (6) Any transactions in Shares by the Issuer or any of its affiliated purchasers must be effected in the ordinary course of business and not for the purpose of facilitating the distribution of the AT1 Contingent Convertible Securities;

(7) Any prospectus or other offering document that is distributed to U.S. investors in connection with the offering of the AT1 Contingent Convertible Securities must disclose the possibility of, or the intention to engage in, transactions in Shares by the Issuer or its affiliated purchasers;

(8) Shares must have an ADTV (within the meaning of Rule 100 of Regulation M) value of at least \$1 million during the two full calendar months immediately preceding, or any consecutive 60 calendar days ending within the 10 calendar days preceding, the determination of the offering price, and Shares must be issued by an Issuer whose common equity securities have a public float value (within the meaning of Rule 100 of Regulation M) of at least \$150 million; and

(9) Except as otherwise exempted herein, the issuance of the AT1 Contingent Convertible Securities shall remain subject to the provisions of Regulation M.

In the event that any material change occurs in the facts or representations in the Request Letter, the Applicants shall promptly present for consideration the facts to staff in the Division of Trading and Markets. This exemption is subject to modification or revocation at any time the Commission determines that such action is necessary or appropriate in furtherance of the purposes of the Exchange Act. In addition, persons relying on this limited exemption are directed to the anti-fraud and anti-manipulation provisions of the Exchange Act, particularly Sections 9(a) and 10(b), and Rule 10b-5 thereunder. Responsibility for compliance with these and any other applicable provisions of the federal securities laws must rest with the persons relying on this exemption.

This Order should not be considered a view with respect to any other question that the proposed transactions may raise, including, but not limited to the adequacy of the disclosure concerning, and the applicability of other federal or state laws to, the proposed transactions.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>13</sup>

Eduardo A. Aleman  
Assistant Secretary

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<sup>13</sup> 17 CFR 200.30-3(a)(6) and (9).